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SUBJECT: THE ALLEGED OVERVALUATION OF THE TURKISH LIRA

REF: a) Ankara 40; b) Ankara 346

This cable has been coordinated with Congen Istanbul.

1.(SBU) Summary: Although the lira appreciated 20 percent in in real terms in 2005, and has hit a 25-year high, the IMF and some respected Turkish economists, however, are far from certain the Turkish lira is overvalued, citing the continued strength of exports. Still, the drumbeat of complaints from labor-intensive industries that cannot compete in the global market will no doubt continue, while thriving, competitive businesses keep quiet. It is a real possibility that the government could respond with populist measures that undercut reforms. End Summary.

The Strength of the Lira.

12. (SBU) By most indicators, the Turkish lira has been remarkably strong over the past two to three years, holding roughly constant against the dollar in nominal terms, even though inflation was considerably higher in Turkey than in virtually all of its trading partners' economies. Depending on which start date is used, the same is broadly true for the euro. The real effective exchange rate - the exchange rate adjusted for inflation differentials with Turkey's trading partners -- has risen to a twenty-five year high, and is higher than the level before the 2001 crisis with its subsequent sharp depreciation after the lira was allowed to float. In 2005 the real effective exchange rate appreciated by 20%.

..May Threaten Export Competitiveness

3.(SBU) The real appreciation of the lira is widely presumed to be squeezing exporters, many of whom say they are maintaining volume only by constantly reinvesting in productivity improvements and by squeezing or eliminating their profit margins to maintain market share. The President of the Turkish Exporters' Association, Oguz Satıcı, has been the most vocal of many critics of the Central Bank's exchange rate policies. Satıcı and his fellow critics perceive the Central Bank to be following a strong lira policy, dismissing the Central Bank's contention it is merely allowing the market to set the exchange rate.

IMF Doubts

14. (SBU) The IMF remains attentive to the risks associated with Turkey's growing current account deficit - these concerns drove the Fund's push for a slight tightening of Turkey's already-tight fiscal policy for the 2006 budget year. However, Fund staff is far from certain that the lira is substantially overvalued. The IMF Resrep, saying export competitiveness will be an important focus for the Fund in the coming months, explained his doubts about lira overvaluation by citing the continued strength of exports. Exports grew 15.8% in value in 2005. The Resrep distinguished between sectors like textiles, in which some companies may be structurally unable to compete in the global market against Chinese competitors, and sectors such as autos. Turkish exporters in the latter sectors continue to gain market share in Europe - hardly what would be expected if the exchange rate is overvalued. Vehicle exports grew 15% in 2005.

Selected Exports by Sector (\$ billions):

	2004	2005	change
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Motor Vehicles	8.29	9.53	15%
Electrical Equipment	4.79	5.42	13%
Machinery	4.13	5.23	27%
Iron and Steel products	7.59	7.68	1%
Apparel	10.80	11.45	6%

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Shared by Turkish Economists

15. (SBU) Several respected Turkish economists also question the wisdom of focusing on the level of the exchange rate. Turkish Treasury Under Secretary Ibrahim Canakci, acknowledges the lira appreciation in real terms, but notes that productivity improvements and lower interest rates have helped control businesses' costs. In a similar vein, Baturalp Candemir, lead economist of EFG Istanbul Securities, and former Treasury Under Secretary Faik Oztrak argue that export competitiveness does not depend solely on the lira's value against other currencies. They attach greater importance to factors such as production costs, raw material prices, and tax rates on business. Empirical studies also show that Turkish exports are more sensitive to the growth rate in the global economy than to the level of the exchange rate.

16. (SBU) Guven Sak, who is both a member of the Central Bank's Monetary Policy Committee and a key advisor to the Chairman of the Turkish Chamber of Commerce, also told us he took a skeptical view of complaints about the overvaluation of the lira. While acknowledging that Turkish industry in low-cost sectors like textiles is losing market share, Sak points out that the scale of the depreciation needed to make Turkish exports competitive with Asian manufacturers would devastate the rest of the economy. Instead, the focus should be on structural reforms, such as modernizing the educational system, and moving Turkish industry toward the production of products that require greater know-how and technology. Sak also advocates giving priority to breaking down structural barriers to trade with countries in the Middle East, Black Sea region and Central Asia, so as to give Turkey a regional competitive edge. Turkish textile companies, for example, may survive by moving production to places

like Egypt, while sourcing high-value inputs from Turkey.

¶7. (SBU) The Economist magazine's Big Mac Index, which attempts to assess the degree of overvaluation of currencies on a purchasing power parity basis, may lend support both to Sak's analysis and that of the IMF. The Big Mac Index recently showed the lira very slightly undervalued against the dollar, with a Turkish Big Mac costing \$3.07 versus \$3.15 in the U.S. On the other hand, all other emerging markets priced their Big Macs more cheaply than Turkey's from the extreme of China's \$1.30 to Chile's \$2.98. This suggests that, while the lira may not be overvalued, labor-intensive manufacturers, may need to move production to lower-cost platforms. The difference between Turkey and other emerging markets may be overstated by the Big Mac Index, however: McDonalds' niche is the urban middle class, which, given Turkey's income inequalities does not represent the broader economy.

Poll Suggests Exporters May not be so Negative

¶8. (SBU) A recent poll by Referans newspaper of 562 businesspeople also suggests exporters are far from unanimous in their frustration at the Central Bank's exchange rate policies. The poll asked the respondents to grade Central Bank Governor Serdengeçti's performance in several areas on a scale of one to ten. On the floating exchange rate regime, the average grade from the entire sample was 6.4. Surprisingly, given the Exporter's Association President's rhetoric, exporters as a sub-group gave Serdengeçti a grade of 5.4, despite the real appreciation of the lira and widespread anecdotal evidence of exporters' problems.

Follow the Money

¶9. (SBU) Governor Serdengeçti tells us (ref b) he believes that his fiercest critics are those who have kept their money offshore, betting against the lira. This is a plausible explanation for the disconnect between the poll results and the continued export

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growth on the one hand, and the exporters' leaders' criticism of the exchange rate on the other. Indeed, Prime Minister Erdogan's recent disclosure of his personal finances, shows he has gained confidence in the lira. Whereas in 2001, the last time Erdogan disclosed his finances, most of his money (72.5%) was in foreign exchange, his 2006 disclosure showed he had 81.7% in lira. As Referans newspaper's headline teasingly expressed it: "Erdogan has confidence in Serdengeçti."

Comment

¶11. (SBU) Under a floating exchange rate regime, the value of the lira is ultimately determined by what people are willing to pay for it, and its "correct" value is unknowable, or irrelevant. There is no doubt, however, that labor-intensive industries that thrived when the lira's real value was lower are suffering and shedding workers as the economy adjusts to the structural changes that have been made since 2001. Complaints from those industries can be expected to continue and intensify, even as other industries more quietly thrive. Though markets are betting on the

continuation of orthodox policies, as elections approach there is a real possibility that the government will respond with populist measures that could undercut reforms. If so, there could be a significant and disruptive depreciation of the lira that could cause even more problems than the recent appreciation.

Wilson